Operational Audits: Lessons for Internal Control

[By Zvi Shalgo, CEO, PTL Group]

In the past three decades, the technological gap between foreign and local goods provided enough of a competitive advantage to cover a serious lack of operational management and infrastructure in China-based foreign-invested enterprises, but this is no longer the case.

China is undergoing an "operational revival" of sorts, and excellence in operational management and infrastructure has become a top priority. Today, as China's market is the business focus for many established players and new entrants.

One of the primary drivers for operational audits in China is that language and cultural barriers prevent China-based GMs from reporting accurate and comprehensive information about on-the-ground operations to a company's headquarters. In fact, much of the information reported is not based on multiple sources, but rather a translation of the opinions of one local manager or partner.

Furthermore, developing internal "self improvement cycles" requires an openness to constructive criticism and multidisciplinary intervention that is uncommon among traditional Chinese managers.

An operational audit can help to fill the informational void and bridge cultural barriers in China to establish checks and balances and strengthen internal control.

Pure financial or legal audits to assess internal control systems are insufficient, as these audits rely on data willingly submitted by the audited company. An operational audit is a key to the accuracy of such data in the first place.

Operational audits can uncover a variety of behaviors that can dramatically affect a company and will likely not be otherwise uncovered, including:

- Employees who signed perfectly legal labor contracts but are not fulfilling their job description (or, even worse, labor contracts for employees who simply do not exist)
- Production losses visible in the factory but not recorded in the books
- Company resource usage recorded in the books that does not happen in real life

Additionally, improved interdepartmental communications and improved management confidence are all by-products of an effective operational audit.

In this article, we highlight five lessons (all gained from operational audits) for establishing effective internal controls:

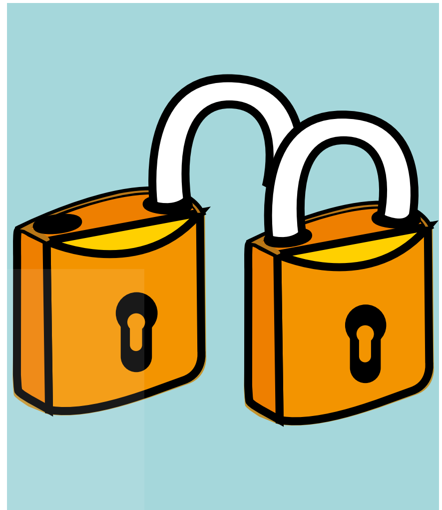
1. Ensure an Active and Accountable Knowledge Transfer
2. Invest in Recruitment Screening
3. Systematize Internal Processes
4. Keep an Eye on Distribution Channels
5. Prioritize Loss Prevention

Ensure an Active and Accountable Knowledge Transfer

A key phenomenon in almost every operational audit is a surprising gap in the execution of control flows between a company's homeland operation and China subsidiary.

Logically, when operating far from home, a special effort should be made to increase controls. In fact, in most pre-penetration business plans (especially those of medium-sized companies), an insufficient amount of resources are planned for managerial knowledge transfer and control methodologies.

Often, several HQ departments supervise



the planning of a China subsidiary, but the plan's execution is handed to one manager and the active and accountable "matrix" involvement of other managers will diminish as they become passive "report lines."

Good plan execution must consider that the general manager (GM) in China is just as in other countries and that subordinates possess most of the professional know-how. Creating checks and balances all along the chain of command that fit the reality on the ground in China should be done by visiting overseas professionals with the professional weight to make decisions for the organization. Furthermore, these professionals should be held accountable for the quality of the internal control mechanisms they design.

Invest in Recruitment Screening

Managers readily shed blood, sweat and tears crafting control measures and preventive decision flows, but often spend just a few hours assessing an individual candidate to implement these measures and flows.

For medium-sized companies, a loss of a manager during the first 2-3 years of penetration can be devastating. Since sales in China, especially during penetration, is relationship-oriented rather than brand-oriented, it is all about the manager. Under these game rules, there is no way to underestimate the importance of the initial screening process of a key manager.

Many management failures occur because of a manager's inability to face changes related to operational growth or the scope of their position, an inability to delegate to and develop subordinates, a focus on short term actions over the big picture, an extreme need for independence related to ego issues, to name a few. These inabilities and tendencies are hard to identify checking a candidate's past record the way most recruiters do, but could be forecasted by professional assessment specialists.

A new tool in China is mass computerized testing suitable for the assessment of large numbers of employees at relatively low cost. These tests are easy to use and include a "credibility test" adopted from security organizations to civil life. The results of such a test will be a major but cost-effective contribution for a job interview, since they point out a candidate's weakness and allow the interviewer to focus his limited time on these. These tests can save a significant amount of search time as well if you use them to prioritize a shortlist of preferred candidates.

Systematize Internal Control Processes

The effort to systematize internal control processes will pay off in the long run in dividends of lowering operational risks.

Return on investment in management systems is not just about numbers, but more about establishing a systematized culture that lends itself to good internal control. Since the local culture is to "look for instructions before doing" rather than to take initiative, a company must create clear plans and make sure there is detailed flow of timely instructions to the relevant employees.

One way of doing just that is using computerized management systems (such as ERP, WMS, CRM) to structure processes. There are many doubts, especially in smaller companies, about the cost of such a system and especially the trouble of training and adopting the new methodology, but such a project is a chance to restructure the management flows of the company in a very detailed way, delegating many actions to subordinates, interconnecting many decisions flows, and minimizing grey areas.

The same logic exists when a relatively small company implements strategic planning processes such as balance scorecards and strategic mapping. This enables a new level of coordination and communication between departments and managers who previously tended to wait for instructions receive enough assurance to become leaders.

While this example may not seem to come directly from the internal control world of "checks and balances," it is essential to encouraging mid-level managers to transmit ideas and initiate their own improving processes – a major step on the way to achieve a structured operation with good internal control.

Keep an Eye on Distribution Channels

While market pressures in China are typical of those around the world, the looser legal environment and the accepted business culture often enables these pressures to have a greater effect in creating unethical business behavior. This is especially true when it comes to distribution channels.

As a company grows, distributors sometimes partner with sales employees to prevent a company from working with other distributors. The sales person only has to say that the new business comes from a "sub distributor" in order to channel the payment flow through "the new partnership" and he becomes a business owner with meaningful earnings from every sale.

The ability to execute such a scam in China is surprisingly easy, largely because most foreign general managers are limited in their contacts with distributors and tend to rely on the sales employee's communications with them. During penetration, fast market expansion by working with a variety of channels can be key to success and such "partnerships" can cripple a company's plans for expansion.

No legal or financial audit can predict the risk of a sales manager that leaves the company holding a large part of the company's business in "his" distribution company, but an operational audit can help managers identify such distribution channel centralization and focus their attention on the sales structure on their segment and the execution of critical NDOs (non-dollar objectives).

Prioritize Loss Prevention

Since preventing losses was traditionally associated with criminal behavior rather than better management for prevention, in many cases loss prevention is still handled by security personnel, which significantly reduces effectiveness.

Specialist professional service firms can analyze losses across departments, applying loss prevention expertise and equipment to help a company update its managerial flows and reduce losses. With careful planning, a security department can become more of a "profit center" than a "cost center."

Final Thoughts

Establishing an effective internal control system requires significant resources and time, but enterprises do not need to approach the challenge in China alone. Another angle to the "operational revival" in China is the increased availability of outsourced professional service solutions.

Service providers can help China enterprises leverage their resources to establish effective operational management and infrastructure across a variety of departments, including back office management, human resources, purchasing, training, logistics, as well as manufacturing.

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